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JAPAN SLOWS DOWN

A rare opportunity for the U.S.

Hard-pressed carmaker Takashi Ishihara: "We are at a loss as to what to do"

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For the cover, Ethan Hoffman of the Archive photo agency shot the chairman of Nissan Motor Co., which is hurting from the strong yen. See page 20.

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WHY BIGGER IS BETTER IN THE AIRLINE WARS

In their sometimes desperate haste to merge, the major airlines are trying to position themselves for a new era of air transport in the U.S. The supercarriers of tomorrow will benefit from economies of scale. But more important, they will control turf.

■ *by Kenneth Labich*

LIKE BIRDS OF PREY, the highfliers of the U.S. airline industry are streaking down from the sky to seize the weak and helpless. The frenzy is likely to reshape air transport in the U.S. faster and more radically than anyone had expected only a few months ago. The acquiring airlines are counting on getting significant economies of scale from their takeovers, but those are almost the least of the incentives. "To continue to exist in this industry, mass is a critical quality," says James V. O'Donnell, vice president of marketing services at Continental Airlines. The long-term goal of the acquisition-minded airline is to become a supercarrier with strategic advantages that will make it impregnable in the territories it serves.

United began the recent flurry of dealmaking less than a year ago by plucking off Pan Am's rich and fast-growing Asian routes. People Express, the pioneering cut-rate carrier, then acquired faltering Frontier. Northwest captured Republic. Texas Air, the owner of Continental and New York Air, made an apparently successful bid for Eastern, which was on the brink of technically defaulting on $2.5 billion in loans. Finally, Trans World Airlines, only recently taken over by New York investor Carl Icahn, announced it was attempting to acquire Ozark.

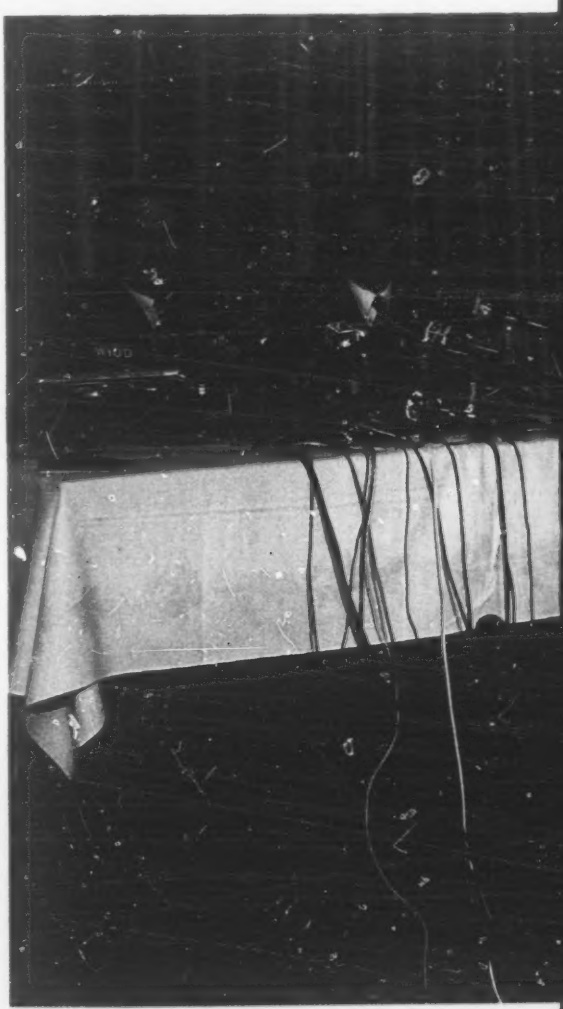
The buying spree has at times an air of desperation. "We saw the industry was shaking down and coalescing," says Larry Martin, a People Express veteran recently installed as Frontier's president. "We felt we had to do something or be left behind."

RESEARCH ASSOCIATE *David Kirkpatrick*

The action is not over yet. American Airlines was reportedly targeted for takeover by Wall Street investors in February, and carriers such as Western and USAir are generally considered potential players. Pan Am, still financially shaky, may also end up on the block. The industry's major analysts predict that ultimately only a half dozen or so big national carriers will still be flying, along with several strong regional airlines and a scattering of small commuter operations.

Economies of scale unquestionably provide plenty of incentive for merger. With oil prices still heading down, the carriers are less eager to buy fuel-efficient but costly new planes. Instead, for the price of three or four new 747s, a carrier can get an entire fleet of used aircraft when it buys out a competitor. TWA will pick up 50 DC-9s with the purchase of Ozark. Acquiring the same number of seats in new planes would have cost about $775 million, more than three times the price. For all his economic woes, Eastern Chairman Frank Borman has amassed a formidable array of 290 planes, ranging from 128 727s to 34 Airbus A-300s.

Combining fleets can also make for more efficient operations. Because Republic has few large planes, it is forced to schedule 19 flights a day that are essentially duplicates. Each goes to the same destination at exactly the same time as another Republic flight. But Northwest has a large fleet of big jets, some underutilized. The combined airlines can now schedule big jets to take care of passengers on those duplicate flights, reducing the number of flights and slashing costs. The new arrangement will also free up 20 to 25



Uneasy allies *in the supercarrier sweepstakes,*

planes for use in expanding schedules elsewhere or opening new routes.

Airlines expect further savings from reduced overhead in ground operations. Says George James, president of Airline Economics Inc., a Washington, D.C., consulting firm, "You may have had two flights a day going into an airport and had to put in ticket agents and other people. If you have four flights, you can utilize those folks more efficiently."

The economies of combining operations will not come quickly in all cases. People Express, operated with a kind of messianic fervor by charismatic Chairman Donald Burr, is a far different kind of operation from Frontier, a more traditional, unionized carrier. "You are talking about merging two very different corporate cultures," says John V. Pincavage, airline analyst at Paine Webber. Melding the two will take time. Texas Air Chairman Frank Lorenzo could have trouble combining Eastern's unionized labor force with his non-union Continental and New York Air crews, particularly since many of the Continental workers took the jobs of union members when Lorenzo put the airline into bankruptcy in 1983 and walked away from his labor contracts. Carl Icahn might want to keep Ozark and TWA staffs apart, particularly since the TWA cabin attendants went on strike in early March, at least until he is able to squeeze some concessions from Ozark's unions.

Once the players combine their operations, however, the game for strategic dominance will begin in earnest. Airline chief executives currently operate like rival warlords who control sectors of a vast battlefield and deploy their forces on occasional excursions into hostile territory. Every big airline has at least one major hub city, where most maintenance facilities are typically located and a large number of flights originate. These hubs, the central strength today of successful airline operations, give carriers the ability to fill the greatest possible number of seats on each flight. For example, an airline might schedule ten or more flights to arrive at its hub from various feeder airports within a one-hour period. Drawing on this flock of arriving passengers, the airline could then fill up a couple of jumbo jets for the lucrative trips to major cities.

JOE A. BENNETT—WOODFIN CAMP

Eastern Chairman Frank Borman and Texas Air chief Frank Lorenzo explain why Eastern is selling out.

WHEN A CARRIER controls a large share of the traffic at a busy airport, the system is virtually foolproof. Elizabeth Bailey, former vice chairman of the Civil Aeronautics Board and now dean of the Carnegie-Mellon University Business School, recently completed a study demonstrating that a carrier controlling 70% to 80% of the volume at an airport will almost certainly be profitable.

Most of the recent deals have been made by carriers seeking to strengthen a hub or snatch a new one. By buying Republic, Northwest took control of the Minneapolis hub, which it had been sharing with Republic. It also acquired Republic's strong hubs in Memphis and Detroit. TWA, which had been sharing the St. Louis hub with Ozark, struck first before another carrier could come in and splinter the business further. People Express, which operates out of Newark, got a foothold for the long run in the West when it acquired Frontier, based in Denver. One of the chief reasons Texas Air wanted Eastern was to plunge into the Southeast by using Eastern's strong hubs in Miami and Atlanta.

United's move into the Pacific made strategic sense because its three major hubs are located in Chicago, Denver, and San Francisco, all ideally located to handle traffic flowing to the West Coast and the Orient. While the Asian business itself is a rich plum, the airline is sure its domestic business will pick up as well because Asia-bound passengers will book the same airline for feeder flights to their international points of departure.

Though United has been flying its new routes to Asia only since early February, Donald C. Moonjian, the airline's senior vice president and general manager for the Pacific division, says that advance reservation figures already show an uptick in domestic business traceable to the new Asian flights. Northwest, United's chief U.S. competitor for Asian business, acquired Republic in large part to gain muscle for the upcoming struggle over the Pacific.

Practically as important as a good hub is a formidable automated reservations system, something Texas is acquiring with Eastern. Such systems, which are developed and marketed by the airlines, have become almost indispensable for the 27,000 or so travel agencies in the U.S. American and United dominate the field; their systems account for about 70% of the total number of computer terminals in use. But Eastern's System One

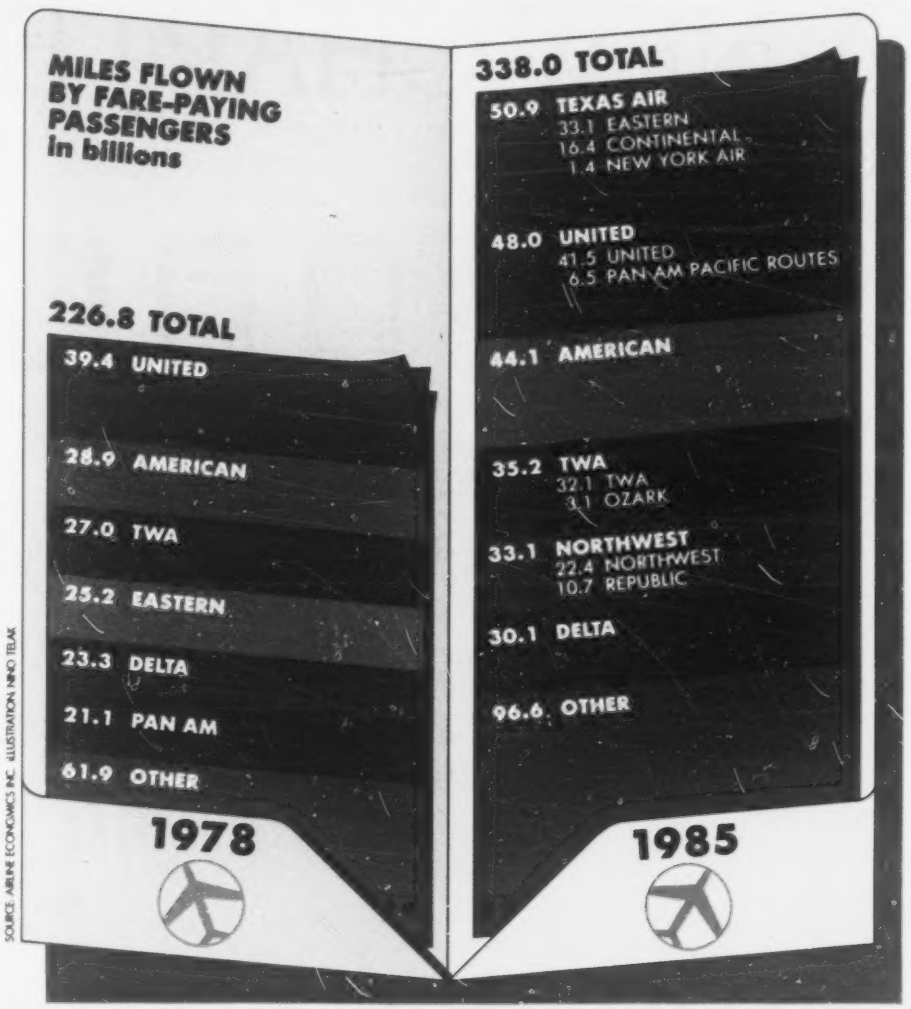
is the third largest and gives Texas Air a healthy push into the market. Travel agents frequently book their clients on the airline that supplies their reservations systems.

IN SOME CASES, the acquiring airline has also gained a hidden strategic asset: slots—the takeoff and landing rights—at crowded airports. Until recently, these slots were rigidly allocated by an industry committee to airlines at Chicago's O'Hare, Washington's National, and New York's La Guardia and Kennedy airports. Carriers that wanted to start flying into these cities were simply out of luck. Starting in April, however, airlines will be able to buy and sell slots. As a result, slots owned by carriers like Eastern, with its 164 at La Guardia, suddenly have cash value as well. While no one yet knows what slots at O'Hare or La Guardia will sell for, Eastern's 107 slots at National are estimated to be worth at least $20 million.

Supercarrier status, with its attendant control over schedules, traffic patterns, and ticketing, will become increasingly important as airlines play out the remaining moves in the drama of deregulation. So far, the game has been going to the frugal: the carriers who have been able to slash their operating costs, especially labor, and win customers with cheap seats. The low-cost carriers are typically the newer ones like People Express or older ones that have won stiff wage cuts or two-tier pay scales. Work-rule changes can also generate important savings. Delta pays some of the highest wages in the industry, but so far has competed successfully because its nonunion employees work longer hours or take on several disparate tasks.

But big airlines are unlikely to operate with vastly different labor costs over the long run, since workers these days can see as clearly as managers that carriers whose costs are out of line will not stay in business long. For the most part, workers have gone along with the takeovers, often gaining equity in their companies in exchange for wage cuts and work-rule changes.

Ironically, the unions have gained new powers even as they have been forced to the wall. By threatening a strike or refusing to make concessions, a union can make or break a deal with a suitor. TWA's unions swung their company's board toward Carl Icahn because of their animosity toward rival bidder Frank Lorenzo. For similar reasons, Lorenzo also lost out to Burr when Frontier was in play. It was a measure of just how badly Borman's labor relations had deteriorated that one of his unions, the International Association of Machinists, apparently preferred a takeover by archenemy Lorenzo to continuing the status quo.



Shifting Shares in a Deregulated Market

Based on what their traffic would have been if they had merged last year, the top six U.S. airlines today control a slightly smaller proportion of a much larger market than the top six did before deregulation. New carriers have proliferated, spreading the business more widely. In the years to come, though, the big airlines are likely to dominate the market.

To date, passengers have been the main beneficiaries of deregulation's upheavals. That should remain the case for the near term, at least. Competition will keep fares low as established players and newcomers, free to enter most markets at will, jockey for position. Says Elizabeth Bailey, with only a touch of hyperbole: "As long as passengers filling empty seats pay more than the meal costs it is worthwhile to get them on board. So fares will stay competitive."

The longer-run outlook, however, worries some industry watchers. As carriers solidify their grips, new entrants will face huge obstacles. Alfred Kahn, the former chairman of the Civil Aeronautics Board and an ardent champion of deregulation, is talking these days like a man who thinks he may have helped create Frankenstein's monster. "The number of carriers in a market is the main factor in keeping prices down," he says. "If carriers in a city are reduced from two to one, I get worried. The possibility that other carriers might come in is not sufficient protection for consumers." If supercarriers do turn their territories into aerial fortresses, even big and powerful competitors may think twice before trying to storm the gates. F